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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information for Common Stock

Our common stock has been quoted on the Nasdaq Global Market under the symbol "BBND" since our initial public offering on March 20, 2007. Prior to that time, there was no public market for our common stock.

The following table sets forth for the indicated periods the high and low sales prices of our common stock as reported by the Nasdaq Global Market.

	High	Low
First quarter	$ 18.19	$ 16.66
Second quarter	$ 21.43	$ 13.11
Third quarter	$ 15.55	$ 6.40
Fourth quarter	$ 6.66	$ 5.14

Dividend Policy

We have never paid any cash dividends on our common stock. Our board of directors currently intends to retain any future earnings to support operations and to finance the growth and development of our business and does not intend to pay cash dividends on our common stock for the foreseeable future. Any future determination related to our dividend policy will be made at the discretion of our board.

Stockholders

As of March 1, 2008, there were 138 registered stockholders of record of our common stock.

Use of Proceeds from Sales of Registered Securities

On March 14, 2007, our registration statement (No. 333-139652) on Form S-1 was declared effective in connection with our initial public offering, pursuant to which we registered an aggregate of 12,305,000 shares of our common stock, of which we sold 7,500,000 shares and certain selling stockholders sold 4,805,000 shares, including the underwriters' over-allotment, at a price to the public of $13.00 per share. The offering closed on March 20, 2007, and, as a result, we received net proceeds of approximately $87.8 million (after underwriters' discounts and commissions of approximately $6.8 million and additional offering-related costs of approximately $2.9 million), and the selling stockholders received net proceeds of approximately $58.1 million (after underwriters' discounts and commissions of approximately $4.4 million). The co-managing underwriters of the offering were Morgan Stanley & Co. Incorporated and Merrill Lynch, Pierce, Fenner & Smith Incorporated.

No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. We did not receive any proceeds from the sale of shares in the initial public offering by the selling stockholders. In March 2007 and April 2007, we used $14.0 million of the net proceeds to repay the outstanding balances under the revolving line of credit and the term loan with Silicon Valley Bank. We have invested the remaining net proceeds for working capital, capital expenditures and other general corporate purposes. In the future, we may also use a portion of our net proceeds to fund acquisitions of complementary businesses, products or technologies. However, we do not have agreements or commitments for any specific acquisitions at this time. Pending the uses described above, we have invested the net proceeds in a variety of short-term, interest-bearing, investment grade securities. There has been no material change in the planned use of proceeds from our initial public offering from that described in the final prospectus filed by us with the SEC pursuant to Rule 424(b) on March 15, 2007.

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

None.

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Item 6. Selected Financial Data

BigBand Networks, Inc. Selected Financial Data

	Years Ended December 31,				
	2007	2006	2005	2004	2003
Consolidated Statements of Opterations Data:					
Net revenues					
Products	$ 144,715	$ 154,013	$ 85,966	$ 31,536	$ 20,014
Services	31,795	22,611	12,013	3,936	1,566
Total net revenues	176,510	176,624	97,979	35,472	21,580
Cost of net revenues					
Products	76,260	74,152	55,933	21,300	8,597
Services	13,414	9,245	3,900	2,221	1,027
Total cost of net revenues	89,674	83,397	59,833	23,521	9,624
Gross profit					
Products	68,455	79,861	30,033	10,236	11,417
Services	18,381	13,366	8,113	1,715	539
Total gross profit	86,836	93,227	38,146	11,951	11,956
Operating expenses					
Research and development	51,862	37,194	30,701	21,582	9,519
Sales and marketing	39,868	29,523	22,729	15,891	10,376
General and administrative	16,286	13,176	6,984	5,782	3,095
Restructuring Charges	2,998	—	—	—	—
Amortization of intangible assets	572	572	573	286	—
In process research and development	—	—	—	966	—
Total operating expenses	111,586	80,465	60,987	44,507	22,990
Operating income (loss)	(24,750)	12,762	(22,841)	(32,556)	(11,034)
Other income (expense), net	608	(1,360)	(1,696)	(957)	(673)
Net income (loss) before provision for income taxes and cumulative effect of change in accounting principle	(24,142)	11,402	(24,537)	(33,513)	(11,707)
Provision for income taxes	1,225	2,525	325	250	—
Net income (loss) before cumulative effect of change in accounting principle	(25,367)	8,877	(24,862)	(33,763)	(11,707)
Cumulative effect of change in accounting principle	—	—	(633)	—	—
Net income (loss)	$ (25,367)	$ 8,877	$ (25,495)	$ (33,763)	$ (11,707)
Net income (loss) per common share:					
Basic	$ (0.52)	$ 0.78	$ (2.36)	$ (4.20)	$ (2.01)
Diluted	$ (0.52)	$ 0.16	$ (2.36)	$ (4.20)	$ (2.01)
Shares used in computing net income (loss) per common share:					
Basic	49,041	11,433	10,794	8,032	5,832
Diluted	49,041	57,053	10,794	8,032	5,832

	2007	2006	2005	2004	2003
Consolidated Balance Sheets Data:					
Cash, cash equivalents and marketable securities	$ 154,520	$ 65,474	$ 24,287	$ 23,796	$ 14,290
Working capital	109,296	25,056	5,812	27,606	16,188
Total assets	218,586	129,050	76,816	80,052	30,862
Current and long-term debt	—	14,536	11,418	12,094	4,662
Preferred stock warrant liabilities	—	3,152	1,642	—	—
Redeemable convertible preferred stock	—	117,307	117,307	118,204	75,060
Common stock and additional paid-in capital	248,201	17,075	14,990	14,049	1,535
Total stockholders' equity (deficit)	$ 111,586	$ (95,614)	$ (107,819)	$ (83,926)	$ (59,388)

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read together with the consolidated financial statements and related notes that are included elsewhere in this prospectus. This discussion contains forward-looking statements, which are based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under "Risk Factors" or in other parts of this prospectus.

Overview

Our company was founded in December 1998, and through 2001 we were engaged principally in research and development. We first generated meaningful product revenues in 2002, principally from our initial media processing platform designed for video. Since 2003, we have expanded our customer base to include six of the ten largest service providers in the United States, including Cablevision, Comcast, Charter, Cox, Time Warner Cable and Verizon. From 2003 through 2005, we experienced significant revenue growth that was derived primarily from cable operators. Beginning in 2005, we commenced sales efforts to telephone companies and began recognizing significant revenues from one of these companies in 2006. In 2007, we initiated a restructuring plan to retire our CMTS platform and realign our business.

Our net revenues are influenced by a variety of factors, including the level and timing of capital spending of our customers, and the annual budgetary cycles of, and the timing and amount of orders from, significant customers. The selling prices of our products vary based upon the particular customer implementation, which impacts the relative mix of software, hardware and services associated with the sale.

Our sales cycle for an initial customer purchase typically ranges from nine to eighteen months, but can be longer. This process generally involves several stages before we can recognize revenues on the sale of our products. As a provider of advanced technologies, we seek to actively participate with our existing and potential customers in the evaluation of their technology needs and network architectures, including the development of initial designs and prototypes. Following these activities, we typically respond to a service provider's request for proposal, configure our products to work within our customer's network architecture, and test our products first in laboratory testing and then in field environments to ensure interoperability with existing products in the service provider's network. Following testing, our revenue recognition depends on satisfying complex customer acceptance criteria specified in our contract with the customer and our customer's schedule for roll-out of the product. Completion of several of these stages is substantially outside of our control, which causes our revenue patterns from a given customer to vary widely from period to period. After initial deployment of our products, subsequent purchases of our products typically have a more compressed sales cycle.

Due to the nature of the cable and telecommunications industries, we sell our products to a limited number of large customers, which have varied over time. For the years ended December 31, 2007, 2006 and 2005, we derived approximately 75%, 79% and 69% of our net revenues from our top five customers, respectively. In 2007, Cox, Time Warner Cable and Verizon each represented 10% or more of our net revenues. In 2006, Comcast, Cox, Time Warner Cable and Verizon each represented 10% or more of our net revenues. We believe that for the foreseeable future our net revenues will be highly concentrated in a relatively small number of large customers. The loss of one or more of our large customers, or the cancellation or deferral of purchases by one or more of these customers, would have a material adverse impact on our revenues and operating results.

We sell our products and services to customers in the United States through our direct sales force. We sell to customers internationally through a combination of direct sales and resellers. In the year ended December 31, 2007, approximately 83% of our net revenues were to customers in the United States and 17% were to customers outside the United States. Domestic sales for 2006 accounted for 89% of our net revenues while sales to customers outside of the United States accounted for 11% of our net revenues.

Net Revenues. We derive our net revenues from sales of, and services for, video and data products. Our product revenues are comprised of a combination of software licenses and hardware. Our primary video products

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include Digital Simulcast, TelcoTV and Switched Digital Video. Our data products include High-Speed Data and Voice-over-IP. Our services include ongoing customer support and maintenance, product installation and training. Our customer support and maintenance is available in a tiered offering at either a standard or enhanced level. The substantial majority of our customers have purchased our enhanced level of customer support and maintenance. The accounting for our net revenues is complex and, as discussed below, we account for revenues in accordance with Statement of Position, or SOP 97-2, *Software Revenue Recognition.*

Cost of Net Revenues. Our cost of product revenues consists primarily of payments for components and product assembly, costs of product testing, provisions taken for excess and obsolete inventory and for warranty obligations and manufacturing overhead. Cost of services revenues is primarily comprised of personnel costs in providing technical support, costs incurred to support deployment and installation within our customers' networks and training costs.

Gross Margin. Our gross profit as a percentage of net revenues, or gross margin, has been and will continue to be affected by a variety of factors, including the mix of software and hardware sold, the mix of revenue between our video products, the average selling prices of our products, and the mix of revenue between products and services. We achieve a higher gross margin on the software content of our products compared to the hardware content. In general, we expect the average selling prices of our products to decline over time, but we seek to maintain our overall gross margins by introducing new products with higher margins, selling software enhancements to existing products, achieving price reductions for components and improving product design to reduce costs. Our gross margins for products are also influenced by the specific terms of our contracts, which may vary significantly from customer to customer based on the type of products sold, the overall size of the customer's order, and the architecture of the customer network, which can influence the amount and complexity of design, integration and installation services. With the discontinuation of the CMTS platform, we expect margins to slightly benefit going forward, as our data product margins were lower.

Operating Expense. Our operating expense consists of research and development, sales and marketing, general and administrative, restructuring charges and amortization of intangible assets. Personnel related costs are the most significant component of operating expense. In 2008, we expect overall operating expense to increase modestly over 2007. We grew from 330 employees at December 31, 2004 to 518 at December 31, 2007. Following our restructuring (which reduced our headcount by nearly 100 people), we expect headcount to increase only modestly in the near-term, but expect outsourced research and development support to increase significantly throughout 2008.

Research and development expense is the largest component of our operating expense and consists primarily of personnel costs, independent contractor costs, prototype expenses and other allocated facilities and information technology expense. The majority of our research and development staff is focused on software development. All research and development costs are expensed as incurred. Our development teams are located in Westborough, Massachusetts, Tel Aviv, Israel, Redwood City, California and Shenzhen, Peoples' Republic of China. We expect our research and development expense to increase modestly in absolute dollars in the near-term periods.

Sales and marketing expense relates primarily to compensation and associated costs for marketing and sales personnel, sales commissions, promotional and other marketing expenses, travel, trade-show expenses, depreciation expenses for demonstration equipment used for trade-shows and allocated facilities and information technology expense. Marketing programs are intended to generate net revenues from new and existing customers and are expensed as incurred. We expect sales and marketing expense to remain relatively flat in absolute dollars in the near-term periods.

General and administrative expense consists primarily of compensation and associated costs for general and administrative personnel, professional fees and allocated facilities and information technology expenses. Professional services consist of outside legal, accounting and information technology and other consulting costs. We expect that general and administrative expense will increase modestly in absolute dollars as we incur legal fees related to a lawsuit filed against Imagine Communications, Inc. alleging patent infringement and legal fees

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related to class action litigation filed against the company. We will also continue to incur additional costs related to being a public company, including the costs of financial reporting, Sarbanes-Oxley Act compliance and director and officer liability insurance.

On October 29, 2007, the Audit Committee of our board of directors authorized a restructuring plan providing for the retirement of the Company's cable modem termination system (CMTS) platform along with an approximate 15% company-wide reduction in force. As a result, the Company recorded a restructuring provision of approximately $3.0 million, which consisted primarily of severance costs, lease termination costs and other associated costs. We expect charges arising from this plan to be insignificant in future periods.

Overall, our restructuring plan to improve efficiency and operating results is expected to generate annual cost savings of approximately $7 million—$8 million related to lower salaries, benefits arrangements and lease costs related to the data business, which savings will be largely offset by anticipated increases in operating expenses in support of the growth of our video business.

2007 Significant Events

- On March 20, 2007, we completed the initial public offering of our common stock. From the sale of 7.5 million shares at an offering price of $13.00 per share, we received net proceeds of approximately $87.8 million.
- For the year ended December 31, 2007, revenues were $176.5 million, which was below our internal forecast for the second half of 2007. Our top five customers accounted for 75% of our net revenues compared to 79% in the year ago period. In 2007, Cox, Time Warner Cable and Verizon each represented 10% or more of our net revenues.
- For the year ended December 31, 2007, gross margin was 49.2% compared to 52.8% in the year ended December 31, 2006. The decrease was primarily due to a $5.0 million inventory charge related to the CMTS platform.
- For the year ended December 31, 2007, net loss was $25.4 million. The net loss for fiscal year 2007 included a non-cash charge of $5.0 million related to the fair value of convertible preferred stock warrants, stock-based compensation expense of $11.6 million, $5.8 million in fixed assets and inventory charges associated with the retirement of the CMTS platform and $3.0 million in restructuring charges.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with GAAP. The preparation of our consolidated financial statements requires our management to make estimates, assumptions, and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the applicable periods. Management bases its estimates, assumptions, and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Different assumptions and judgments would change the estimates used in the preparation of our consolidated financial statements, which, in turn, could change the results from those reported. Our management evaluates its estimates, assumptions and judgments on an ongoing basis.

The critical accounting policies requiring estimates, assumptions, and judgments that we believe have the most significant impact on our consolidated financial statements are described below.

Revenue Recognition

We derive net revenues from sales of our products and services. Product revenues consists of sales of our hardware and software products. Shipping charges, which have been insignificant to date, are included in product revenues, and the related shipping costs are included in cost of product revenues. Service revenues consists of customer support and maintenance, program management and training activities.

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Software is essential to the functionality of our products. We provide software updates that we choose to develop, which we refer to as unspecified software updates, and enhancements related to our products through support service contracts. As a result, we account for revenue in accordance with Statement of Position, *Software Revenue Recognition as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, or SOP 97-2, for all transactions involving the sale of software.

We recognize product revenues when all of the following have occurred: (1) we have entered into an arrangement with a customer; (2) delivery has occurred; (3) customer payment is deemed fixed or determinable and free of contingencies and significant uncertainties; and (4) collection is probable. Pricing is considered fixed or determinable at the execution of a customer arrangement, based on specific products and quantities to be delivered at specified prices. We assess the ability to collect from our customers based on a number of factors, including credit-worthiness and any past transaction history of the customer. In the limited circumstances where we may have a customer not deemed creditworthy, we will defer all revenues from the arrangement until payment is received and all other revenue recognition criteria have been met.

Product revenues consist of hardware and a perpetual license to our software. Product revenues are generally recognized upon transfer of title to the customer assuming all other revenue recognition criteria are met, except for customers that require contractually negotiated acceptance of our products, in which case we recognize revenues at the earlier of receipt of acceptance from the customer or when the rejection period lapses. Substantially all of our contracts, including those with resellers, do not include rights of return. To the extent that our agreements contain such terms, we recognize revenue when the amount of future returns can be reasonably estimated in accordance with the guidance under Statement of Financial Accounting Standards No. 48 (as amended), *Revenue Recognition When Right of Return Exists*. Returns to date have been insignificant. Our resellers generally do not maintain any inventory and only receive products from us when an end-user customer has committed to the purchase.

Most of our products are sold in combination with customer support and maintenance services, which consist of software updates and product support. Software updates provide customers with rights to unspecified software updates that we choose to develop and to maintenance releases and patches released during the term of the support period. Product support services include telephone support, remote diagnostics, email and web access, access to on-site technical support personnel and repair or replacement of hardware in the event of damage or failure during the term of the support period. Net revenues for support services are recognized on a straight-line basis over the service contract term, which is generally one year. Installation services and training services, when provided, are also recognized in service revenues when performed.

We use the residual method, as allowed by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, to recognize revenue when a product agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence, or VSOE, of the fair value of all undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and any remaining amount provided for under the contract is recognized. When the undelivered element is customer support and maintenance, that portion of the revenue is recognized ratably over the term of the customer support arrangement, and the remaining revenue associated with the arrangement is recognized when all the other criteria of SOP 97-2 are satisfied. We have established VSOE of the fair value of our customer support and maintenance and other services based upon the normal pricing and discounting practices for those services when sold separately and based on the prices at which our customers have renewed their customer support and maintenance arrangements. If evidence of the fair value of one or more undelivered elements does not exist, all revenues are deferred and recognized when delivery of those elements occurs or when fair value can be established. For example, in situations where we sell a product which includes a commitment for delivery of a future specified software feature or functionality, we defer revenue recognition for the entire arrangement until the specified software feature or functionality is delivered. In those instances where the only undelivered element is for customer support and there is no evidence of fair value for this support, the product and customer support revenue are deferred and revenue is recognized ratably over the support period.

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Valuation of Inventories

Inventories are stated at the lower of cost or market. Cost is determined on the first-in, first-out method. We provide for excess and obsolete inventories after evaluation of historical sales and usage, current economic trends, market conditions, product rationalization, forecasted sales, product lifecycle and current inventory levels. Provisions for excess and obsolete inventory are recorded as cost of net product revenues. This evaluation requires us to make estimates regarding future events in an industry where rapid technological changes are prevalent. It is possible that increases in inventory write-downs may be required in the future if there is a decline in market conditions or if changes in expected product lifecycles occur. If market conditions improve or product lifecycles extend, we may have greater success in selling inventory that had previously been written down. In either event, the actual value of our inventory may be higher or lower and recognition of such difference will affect our cost of net revenues in a future period, which could materially affect our operating results and financial position.

Warranty Liabilities

We warrant our products against defects in materials and workmanship. Generally, we warrant our products for one year. For our largest telephone company customer, we warrant our products for five years. A provision for estimated future costs related to warranty activities is recorded as a component of cost of net product revenues when the product revenues are recognized based upon our historical product failure rates and historical costs incurred in correcting product failures. The recorded amount is adjusted from time to time for specifically identified warranty exposures. Where we have experienced higher product failure rates and costs of correcting product failures change, or our estimates relating to specifically identified warranty exposures changed, we have recorded additional warranty reserves and may be required to do so in future periods. If our estimated reserves differ from our actual warranty costs based on historical experience, we may reverse a portion of or increase such provisions in future periods. In the event we change our warranty reserve estimates, the resulting charge against future cost of sales or reversal of previously recorded charges may materially affect our gross margins and operating results.

Stock-Based Compensation

We grant options to purchase our common stock to our employees, directors and to non-employees under our equity incentive plan. Eligible employees can also purchase shares of our common stock under our employee stock purchase plan at the lower of: i) 85% of the fair market value on the first day of a six-month offering period; or (ii) 85% of the fair market value on the last date of the six-month offering period.

Prior to January 1, 2006, we accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board, Opinion No. 25, *Accounting for Stock Issued to Employees* , or APB 25, and Financial Accounting Standards Board Interpretation, or FIN 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25*, and had adopted the disclosure only provisions of Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation* (SFAS 123) and SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (SFAS 148) using the minimum value method.

In accordance with APB 25, stock-based compensation expense, which is a non-cash charge, resulted from stock option grants at exercise prices that, for financial reporting purposes, were deemed to be below the estimated fair value of the underlying common stock on the date of grant. During the years ended December 31, 2007, 2006 and 2005, we amortized $0.9 million, $1.1 million, and $1.1 million of deferred compensation expense, net of reversals, respectively. As of December 31, 2007 we have a remaining balance of $0.2 million that will be amortized in future periods, net of reversals.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment* , using the prospective transition method, which requires us to apply the provisions of SFAS 123(R) to new awards granted, and to awards modified, repurchased or cancelled, after the effective date. Under this transition

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method, stock-based compensation expense recognized beginning January 1, 2006 is based on a combination of the following: (a) the grant-date fair value of stock option awards and employee stock purchase plan shares granted or modified after January 1, 2006; and (b) the amortization of deferred stock-based compensation related to stock option awards granted prior to January 1, 2006, which was calculated using the intrinsic value method as previously permitted under APB 25.

Under SFAS 123(R), we estimated the fair value of stock options granted using a Black-Scholes option-pricing formula and a single option award approach. This model utilizes the estimated fair value of common stock and requires that, at the date of grant, we use the expected term of the option, the expected volatility of the price of our common stock, risk free interest rates and expected dividend yield of our common stock. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Options typically vest with respect to 25% of the shares one year after the options' vesting commencement date and the remainder ratably on a monthly basis over the following three years. Employee stock purchase plan shares vest over six months, and include two purchase dates per year. Actual results may differ substantially from these estimates. In valuing share-based awards under SFAS 123(R), significant judgment is required in determining the expected volatility of our common stock and the expected term individuals will hold their share-based awards prior to exercising. Expected volatility of the stock is based on our peer group in the industry in which we do business because we do not have sufficient historical volatility data for our own stock. The expected term of options granted represents the period of time that options granted are expected to be outstanding and was calculated using the simplified method permitted by the SEC Staff Accounting Bulletin No., 107. In the future, as we gain historical data for volatility in our own stock and the actual term employees hold our options, expected volatility and expected term may change which could substantially change the grant-date fair value of future awards of stock options and ultimately the expense we record.

As of December 31, 2007, the total compensation cost related to stock-based awards granted under SFAS 123R to employees and directors but not yet amortized was approximately $38.2 million, net of estimated forfeitures. These costs, adjusted for changes in estimated forfeiture rates from time to time, will be amortized over the next four years. Stock-based compensation expense for awards granted to employees and directors for the years ended December 31, 2007 and 2006 was approximately $11.3 million and $2.5 million, respectively.

We account for stock compensation arrangements with non-employees in accordance with SFAS 123 and Emerging Issues Task Force, or EITF, No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* , using a fair value approach. For stock options granted to non-employees, the fair value of the stock options is estimated using a Black-Scholes valuation model. In 2007 we granted 31,250 options and 1,875 restricted shares to non employees and recognized stock based compensation expense of $0.3 million in 2007 associated with these awards.

Allowances for Doubtful Accounts

We make judgments as to our ability to collect outstanding accounts receivable and provide allowances for the applicable portion of accounts receivable when collection becomes doubtful. We provide allowances based upon a specific review of all significant outstanding invoices, analysis of our historical collection experience and current economic trends. If the historical data used to calculate the allowance for doubtful accounts does not reflect our future ability to collect outstanding accounts receivable, additional provisions for doubtful accounts may be needed and our future results of operations could be materially affected. Our allowance for doubtful accounts was approximately $142,000 and $152,000 at December 31, 2007 and 2006, respectively.

Impairment of Intangible Assets and Other Long-lived Assets

We assess impairment of long-lived assets for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. Circumstances which could trigger a review include, but are not limited to: significant decreases in the market price of the asset; significant adverse changes in the business climate or legal factors; accumulation of costs significantly in excess of the amount originally expected

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for the acquisition or construction of the asset; current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset; or current expectation that the asset will more likely than not be sold or disposed of significantly before the end of its estimated useful life.

Recoverability is assessed based on the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. An impairment loss is recognized in the consolidated statements of operations when the carrying amount is not recoverable and exceeds fair value, which is determined on a discounted cash flow basis.

We make estimates and judgments about future undiscounted cash flows and fair value. Although our cash flow forecasts are based on assumptions that are consistent with our plans, there is significant exercise of judgment involved in determining the cash flows attributable to a long-lived asset over its estimated remaining useful life. Our estimates of anticipated future cash flows could be reduced significantly in the future. As a result, the carrying amount of our long-lived assets could be reduced through impairment charges in the future. Changes in estimated future cash flows could also result in a shortening of estimated useful life of long-lived assets including intangibles for depreciation and amortization purposes.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carry forwards are utilized. Accordingly, realization of our deferred tax assets is dependent on future taxable income against which these deductions, losses, and credits can be utilized. We must assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance.

Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our net deferred tax assets. As of December 31, 2007, we recorded a full valuation allowance against our deferred tax assets arising from U.S. operations since, based on the available evidence, we believed at that time it was more likely than not that we would not be able to utilize all of these deferred tax assets in the future. We intend to maintain the full valuation allowances against our U.S. deferred tax assets until sufficient evidence exists to support the reversal of the valuation allowances. We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted.

Effective January 1, 2007, we adopted Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109* ("FIN 48"). FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes." The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement. Management judgment is required to perform the evaluation and measurement process. Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The Company's policy to include interest and penalties related to unrecognized tax benefits within the Company's

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provision from income taxes did not change. The Company's only major tax jurisdictions are the United States and Israel. The tax years 1998 through 2007 remain open and subject to examination by the appropriate governmental agencies in the U.S. and the tax years 2004 through 2007 remain open and subject to examination by the appropriate governmental agencies in Israel. The Company's total amount of unrecognized tax benefits as of December 31, 2007 was $1.4 million.

Results of Operations

The following table shows the percentage relationships of the listed items from our consolidated statements of operations, as a percentage of total net revenues for the periods indicated:

	Years Ended December 31,		
	2007	2006	2005
Consolidated Statements of Operations Data:			
Net revenues			
Products	82.0%	87.2%	87.7%
Services	18.0%	12.8%	12.3%
Total net revenues	100.0%	100.0%	100.0%
Cost of net revenues			
Products	43.2%	42.0%	57.1%
Services	7.6%	5.2%	4.0%
Total cost of net revenues	50.8%	47.2%	61.1%
Total gross profit	49.2%	52.8%	38.9%
Operating expense			
Research and development	29.4%	21.1%	31.3%
Sales and marketing	22.6%	16.7%	23.2%
General and administrative	9.2%	7.5%	7.1%
Restructuring charges	1.7%	0.0%	0.0%
Amortization of intangible assets	0.3%	0.3%	0.6%
Total operating expense	63.2%	45.6%	62.2%
Operating income (loss)	(14.0)%	7.2%	(23.3)
Interest income	3.9%	0.9%	0.6%
Interest expense	(0.4)%	(1.0)%	(1.7)%
Other expense, net	(3.2)%	(0.7)%	(0.7)%
Net income (loss) before provision for income taxes and cumulative effect of change in accounting principle	(13.7)%	6.4%	(25.1)%
Provision for income taxes	0.7%	1.4%	0.3%
Net income (loss) before cumulative effect of change in accounting principle	(14.4)%	5.0%	(25.4)%
Cumulative effect of change in accounting principle	0.0%	0.0%	(0.6)%
Net income (loss)	(14.4)%	5.0%	(26.0)%

Years Ended December 31, 2007 and 2006

Net Revenues. Net revenues for 2007 were $176.5 million compared to $176.6 million for 2006, or a decrease of $0.1 million. Revenues from our top five customers comprised 75% and 79% of net revenues for 2007 and 2006, respectively. During 2007, revenues from customers in the United States comprised 83% of net revenues compared to 2006, in which customers in the United States comprised 89% of net revenues. The increase in 2007 revenues from customers outside the United States was partly a result of approximately $5.3 million in revenues recognized from customers in China that were previously deferred.

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Products revenues for 2007 were $144.7 million compared to $154.0 million for 2006, a decrease of $9.3 million, or 6.0%. This decrease was primarily due to an $8.4 million decrease in revenues from our Data products with revenue from the Video products staying relatively flat. The decrease in Data product revenues was due to the unsuccessful transition to the new modular CMTS product application, which caused delays in revenue recognition, and the retirement of the CMTS platform under the plan approved by the Audit Committee of the Board of Directors in October 2007.

Services revenues for 2007 were $31.8 million compared to $22.6 million for 2006, an increase of $9.2 million, or 40.6%. This increase was primarily due to an increase in service revenues related to additional orders for product and licenses along with increases in maintenance renewals and service revenues related to prior year installations for our Telco customers.

Gross Profit/Gross Margin. Gross profit for 2007 was $86.8 million compared to $93.2 million for 2006, a decrease of $6.4 million, or 3.6%. Gross margin decreased to 49.2% in 2007 compared to 52.8% in 2006 principally as a result of lower product gross margins and, to a lesser extent, as a result of reduced services gross margins.

Products gross margin for 2007 was 47.3% compared to 51.9% for 2006. This decrease was primarily related to a $5.0 million inventory charge related to the discontinuation of the CMTS platform along with higher manufacturing overhead charges arising from increased head count. Product gross margin in 2007 also included a $0.6 million increase in stock compensation expense compared to 2006.

Services gross margin for 2007 was 57.8% compared to 59.1% for 2006. The decrease in 2007 was primarily related to an increase in services organization headcount to support the customer installed base, which was not offset by the same increase in services revenue. To a lesser extent, the lower services margins was the result of installation and training revenues (which has relatively lower gross margins than customer support revenue) representing a larger portion of services revenues. Services gross margin included a $0.6 million increase in stock compensation expense compared to 2006.

Research and Development. Research and development expense was $51.9 million for 2007, or 29.4% of net revenues, compared to $37.2 million in the comparable period of 2006, or 21.1% of net revenues. The $14.7 million increase was primarily due to increased compensation costs of $9.3 million attributable to an increase in employee headcount to support new product offerings. To a lesser extent, research and development expense increased as a result of an increase in depreciation expense of $1.3 million and an increase in travel expense of $0.5 million. This increase in compensation expense includes an increase of $2.8 million in stock-based compensation.

Sales and Marketing. Sales and marketing expense was $39.9 million, or 22.6% of net revenues, for 2007 compared to $29.5 million, or 16.7% of net revenues, during 2006. The $10.4 million increase was primarily due to increased compensation costs of $8.1 million from additional employee headcount for which we incurred increased commissions and salaries. In addition, 2007 travel-related cost increased by $1.0 million along with a $0.6 million increase in marketing related activities due to increased employee headcount. This increase in compensation expense includes an increase of $3.5 million in stock-based compensation.

General and Administrative. General and administrative expense was $16.3 million, or 9.2% of net revenues, for 2007 compared to $13.2 million, or 7.5% of net revenues, during 2006. The $3.1 million increase was primarily due to increased compensation costs of $3.7 million attributable to an increase in employee headcount, including additional accounting and finance personnel. To a lesser extent, general and administrative expense increased as a result of an increase of $1.2 million in legal fees related to patent infringement and class action litigation, and a $0.5 million increase in insurance costs attributable to being a public company. These additional 2007 costs were offset by a $1.1 million decrease in spending related to our preparation for becoming a public company, including consulting costs associated with Sarbanes-Oxley compliance and improvement to our ERP systems. This increase in compensation expense includes an increase of $1.5 million in stock-based compensation.

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Restructuring Charges. In October 2007 we restructured our business and decreased company-wide headcount by approximately 15% and to retire our CMTS platform. This resulted in a restructuring charge of approximately $3.0 million. Severance payments and related charges of approximately $2.2 million consisted primarily of salary, expected payroll taxes, and medical benefits for terminated employees. Lease termination costs of $0.7 million are related to the closure of five offices along with $0.1 million in other expenses. We do not anticipate 2008 net revenues to be significantly impacted due to the restructuring plan, however, we expect gross margins to improve slightly in 2008, as the CMTS platform historically earned lower gross margins.

Other Expense, Net. Other expense, net includes interest income, interest expense and other expenses. It increased $2.0 million to an income of $0.6 million in 2007 from an expense of $1.4 million in 2006. Other expense, net in 2007 included approximately $5.0 million in charges for fair value adjustments of our preferred stock warrants under FSP 150-5. Interest income increased by $5.4 million to $6.9 million from $1.5 million for 2006 as a result of interest earned on investment in marketable securities from the proceeds received from our initial public offering. The proceeds were also used in 2007 to repay outstanding borrowings, which resulted in decreased interest expense of $1.1 million from 2006.

Provision for Income Taxes. We incurred U.S. operating losses in all years from inception through 2007, except in 2006. Because of net operating loss carryforwards in the United States, the provision for income taxes of $1.2 million and $2.5 million for 2007 and 2006, respectively, were primarily related to provisions for foreign income taxes. As of December 31, 2007, we had net operating loss carryforwards for federal and state income tax purposes of $90.8 million and $45.1 million, respectively. As of December 31, 2007, the portion of the federal and state operating loss carryforwards, which relates to stock option benefits is approximately $8.8 million which will be recorded in equity when those losses reduce income taxes payable. We also had federal research and development tax credit carryforwards of approximately $2.3 million and state research and development tax credit carryforwards of approximately $1.0 million. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which is uncertain. Accordingly, the net deferred tax assets arising from U.S. operations have been fully offset by a valuation allowance. If not utilized, the federal net operating loss and tax credit carryforwards will expire between 2019 and 2027, and the state net operating loss and tax credit carryforward will expire in different years depending on the specific state, ranging from 2009 to indefinite. Utilization of these net operating losses and credit carryforwards will likely be subject to an annual limitation due to the provisions of Section 382 of the Internal Revenue Code.

Years Ended December 31, 2006 and 2005

Net Revenues. Net revenues for 2006 were $176.6 million compared to $98.0 million for 2005, an increase of $78.6 million, or 80.3%. Revenues from our top five customers comprised 79% and 69% of net revenues for 2006 and 2005, respectively. During 2006, revenues from customers in the United States comprised 89% of net revenues, compared to 2005, in which customers in the United States comprised 83% of net revenues.

Products revenues for 2006 were $154.0 million compared to $86.0 million for 2005, an increase of $68.0 million, or 79.2%. This increase was primarily due to a $87.6 million increase in revenues from our video products, partially offset by a $19.6 million decrease in revenues from our data products. The $87.6 million increase in video products was attributable to the first recognition of significant net revenues from our TelcoTV product and significant growth in revenues from our Switched Digital Video product. The decrease in revenues from data products was almost entirely due to $18.8 million of revenues recognized in 2005 following satisfaction of customer acceptance criteria for product shipped to a single customer in 2004.

Services revenues for 2006 was $22.6 million compared to $12.0 million for 2005, an increase of $10.6 million, or 88.2%. This $10.6 million increase was primarily due to an increase in customer support and maintenance revenues earned on a larger installed base of products.

Gross Profit/Gross Margin. Gross profit for 2006 was $93.2 million compared to $38.1 million for 2005, an increase of $55.1 million, or 144.4%. Gross margin increased to 52.8% in 2006 compared to 38.9% in 2005.

Products gross margin for 2006 was 51.9% compared to 34.9% for 2005. This increase was due to a shift in product mix in 2006 towards video products, which have relatively higher gross margins. Gross margin in 2005 was adversely impacted by the sale of inventory acquired in the BAS transaction. Under purchase accounting, the carrying value of this inventory was increased by $4.7 million to its fair market value at the time of acquisition. The sale of a portion of this inventory reduced products gross margin by $3.5 million, or 4.1% of products revenues, in 2005. In addition, gross margins in 2005 decreased as a result of a physical inventory write-down of $1.8 million and a specific warranty provision of $1.5 million recorded for the expected cost of repairing defective subcomponents.

Services gross margin for 2006 was 59.1% compared to 67.5% for 2005. In 2005, our business grew more rapidly than our level of support personnel could support at the time. This resulted in relatively high margins with respect to services during 2005. In 2006, we made a planned increase to our services personnel headcount to support not only the increase in customer installed base in 2005, but also the anticipated increase in our installed base from our future business. This resulted in a relative decline in gross margins in 2006.

Research and Development. Research and development expense was $37.2 million for 2006, or 21.1% of net revenues, compared to $30.7 million in the comparable period of 2005, or 31.3% of net revenues. The $6.5 million increase was primarily due to increased compensation costs of $4.7 million attributable to an increase in employee headcount and $1.4 million attributable to increased sub-contractor expenses. Research and development expense included stock-based compensation expense of $1.0 million and $0.5 million during 2006 and 2005, respectively.

Sales and Marketing. Sales and marketing expense was $29.5 million, or 16.7% of net revenues, for 2006 compared to $22.7 million, or 23.2% of net revenues, during 2005. The $6.8 million increase was primarily due to increased compensation costs of $4.6 million resulting from increased commissions and salaries, as well as increased headcount in support of our overall growth. In addition, travel and entertainment cost increased by $0.9 million. Sales and marketing expense included stock-based compensation expense of $0.6 million and $0.3 million during 2006 and 2005, respectively.

General and Administrative. General and administrative expense was $13.2 million, or 7.5% of net revenues, for 2006 compared to $7.0 million, or 7.1% of net revenues, during 2005. The $6.2 million increase was primarily due to increased compensation costs of $2.5 million attributable to an increase in employee headcount, including additional accounting and finance personnel, an increase of $2.6 million in spending related to our preparation for becoming a public company, including consulting costs associated with Sarbanes-Oxley compliance and improvement to our ERP systems, and $0.8 million in costs associated with our audit committee's independent investigation of the accounting for revenue in our China operations. General and administrative expense included stock-based compensation expense of $0.5 million and $0.2 million during 2006 and 2005, respectively.

Other Expense, Net. Other expense, net includes interest income, interest expense and other expense, net and was $1.4 million in 2006, compared to $1.7 million in 2005. Other expense, net consisted primarily of expenses associated with changes in the fair value of our outstanding preferred stock warrants, interest expense and interest income. The change in other expense, net was primarily due to the adoption of FSP 150-5 on July 1, 2005, which resulted in a $1.5 million expense arising from the increase in value of preferred stock warrants during the 2006 period. This compares to a $0.1 million expense from the increase in value of preferred stock warrants during 2005. These increases were partially offset by $0.6 million of remaining proceeds received upon satisfaction of an escrow condition on the sale of an investment obtained in conjunction with our BAS acquisition.

Provision for Income Taxes. We incurred U.S. operating losses in all years from inception through 2005. Because of net operating loss carryforwards in the United States, the provision for income taxes of $2.5 million and $0.3 million for 2006 and 2005, respectively, were primarily related to provisions for foreign income taxes. For the year ended December 31, 2006, $1.3 million of the provision for income taxes was related to the conclusion of a tax audit in Israel. The resolution of the audit resulted in amounts being due which were in excess

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of the amounts estimated and in excess of amounts previously recorded. The $1.3 million includes the effects for the years ended December 31, 1999 through 2003 that were covered by the tax audit and the expected effect for the years ended December 31, 2004 through 2006 based on the outcome of the tax audit. As of December 31, 2006, we had net operating loss carryforwards for federal and state income tax purposes of $93.8 million and $46.0 million, respectively. We also had federal research and development tax credit carryforwards of approximately $2.4 million and state research and development tax credit carryforwards of approximately $2.3 million. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which is uncertain. Accordingly, the net deferred tax assets arising from U.S. operations have been fully offset by a valuation allowance. If not utilized, the federal net operating loss and tax credit carryforwards will expire between 2019 and 2026, and the state net operating loss and tax credit carryforward will expire between 2008 and 2026. Utilization of these net operating losses and credit carryforwards will likely be subject to an annual limitation due to the provisions of Section 382 of the Internal Revenue Code.

Liquidity and Capital Resources

Prior to our IPO in March 2007, we funded our operations primarily through the private sales of our convertible preferred stock and collections from our customers and, to a lesser extent, borrowings under our credit facility and term loan. In March 2007, we completed our IPO which provided us with aggregate net proceeds of $87.8 million. As of December 31, 2007, our cash, cash equivalents and marketable securities totalled $154.5 million.

Operating Activities

Our operating activities generated cash in the amount of $20.9 million for the year ended December 31, 2007. This cash from operating activities was a result of a net loss of $25.4 million, offset by non-cash expenses of $11.6 million in stock-based compensation expense, and $9.8 million in depreciation and amortization expense. This loss was further offset by changes in operating assets and liabilities, primarily the increase in deferred revenues of $16.7 million and a decrease in accounts receivable of $6.1 million due to the timing of shipments and collections from customers.

Our operating activities generated cash in the amount of $48.8 million for the year ended December 31, 2006, primarily due to net income of $8.9 million, a decrease in inventory of $14.4 million and an increase in deferred revenues of $21.8 million, an increase in accrued and other liabilities of $7.3 million, and an increase in accounts payable of $6.3 million. These changes resulted primarily from the significant growth in our business, the timing of shipments and payments to vendors, our efforts to manage and monitor inventory balances and the increase in deferred revenue due to the timing of revenue recognition under our revenue recognition policy. The 2006 decrease in inventory compared to 2005 resulted from a more significant emphasis on efficiently managing our inventory levels through working with our suppliers. These changes were partially offset by an increase in trade receivables of $19.3 million due to the growth in our business. We also had non-cash charges of $10.6 million, comprised primarily of $6.1 million in depreciation on property and equipment, $2.5 million in stock-based compensation expense and $1.5 million related to the increase in fair value of preferred stock warrants during the period.

Our operating activities generated cash in the amount of $1.4 million in the year ended December 31, 2005, primarily due to an increase in deferred revenues of $18.7 million and an increase in other accrued liabilities of $2.7 million. These changes resulted primarily from the growth in our business, the timing of shipments and the satisfaction of revenue recognition criteria under our revenue recognition policy. Operating cash flow was also favorably affected by a decrease in trade receivables of $6.1 million due to the timing of collections. These changes were largely offset by a loss of $25.5 million, an increase in inventory of $7.7 million, an increase in prepaid and other current assets of $1.3 million and a decrease in accounts payable of $1.5 million due to the timing of payments to vendors. We also had non-cash charges of $9.0 million, comprised primarily of $5.9 million in depreciation on property and equipment, $1.1 million in stock-based compensation expense and $0.7 million related to the increase in value of preferred stock warrants during the period.

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Investing Activities

Our investing activities used cash of $85.0 million in the year ended December 31, 2007, primarily from net purchases of marketable securities of $72.2 million and the purchase of property and equipment of $12.3 million primarily to support our new product offerings. These capital expenditures consisted primarily of computer and test equipment and software purchases. As of December 31, 2007, we had invested $11.7 million in auction rate securities, which were all AAA rated at that time by one or more of the major credit rating agencies and collateralized by student loans with a significant portion of such collateral being guaranteed by the U.S. government through its education loan programs. At the time of each auction rate security's periodic auction reset, we generally can determine whether to reinvest in the security. We did not reinvest in any of these auction rate securities and as of January 17, 2008, we held no investments in auction rate securities.

Our investing activities used cash of $30.2 million in the year ended December 31, 2006, primarily from net purchases of marketable securities of $20.0 million and the purchase of property and equipment of $10.9 million to support the business. These capital expenditures consisted primarily of computer and test equipment and software purchases.

Our investing activities used cash of $7.7 million in the year ended December 31, 2005, primarily from net purchases of marketable securities of $6.9 million and the purchase of property and equipment of $6.0 million. These capital expenditures consisted primarily of computer and test equipment and software purchases. These uses of funds for investing activities were partially offset by $5.3 million in proceeds from the sale of an investment acquired in connection with the BAS acquisition in 2004.

Financing Activities

Our financing activities provided cash of $80.7 million in the year ended December 31, 2007, primarily from our IPO which provided us with aggregate net proceeds of $87.8 million, proceeds of $5.7 million from the issuance of common stock from the exercise of options and employee stock purchase plans, and proceeds of $1.8 million received from the exercise of warrants to purchase common stock. These increases were partially offset by the repayment of loans and capital leases of $14.5 million.

Our financing activities provided cash of $2.7 million in the year ended December 31, 2006, primarily from a net increase in borrowings of $2.8 million, and proceeds of $0.8 million received from the exercise of options to purchase our common stock, offset by $0.7 million of payment of costs to professional service providers associated with our initial public offering.

Our financing activities used cash of $0.2 million in the year ended December 31, 2005, primarily from repayments of loans and payments against capital lease obligations of $0.7 million, offset by proceeds of $0.5 million received from the exercise of options to purchase our common stock.

We believe that our existing cash, cash equivalents and marketable securities will be sufficient to meet our anticipated cash needs for at least the next year. Our future capital requirements will depend on many factors including our rate of revenue growth, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the timing of introductions of new products and enhancements to existing products, the costs to ensure access of adequate manufacturing capacity and the continuing market acceptance of our products. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be harmed.

Contractual Obligations and Commitments

The following summarizes our contractual obligations at December 31, 2007:

	Payments Due by Period (in thousands)				
	Total	Less Than 1 Year	2 -3 Years	4 -5 Years	Thereafter
Operating lease obligations	$ 12,911	$ 3,161	$ 5,333	$ 4,296	$ 121

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Off-Balance Sheet Arrangements

As of December 31, 2007, we have no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission's Regulation S-K.

Effects of Inflation

Our monetary assets, consisting primarily of cash, marketable securities and receivables, are not affected by inflation because they are short-term and in the case of cash are immaterial. Our non-monetary assets, consisting primarily of inventory, intangible assets, goodwill and prepaid expenses and other assets, are not affected significantly by inflation. We believe that the impact of inflation on replacement costs of equipment, furniture and leasehold improvements will not materially affect our operations. However, the rate of inflation affects our cost of goods sold and expenses, such as those for employee compensation, which may not be readily recoverable in the price of products and services offered by us.

Recent Accounting Pronouncements

See Note 2 of the Notes to Consolidated Financial Statements included in this annual report for recent accounting pronouncements that could have an effect on us.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Sensitivity

The primary objectives of our investment activity are to preserve principal, provide liquidity and maximize income without significantly increasing risk. Some of the securities we invest in are subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, money market funds, government and non-government debt securities and certificates of deposit. The risk associated with fluctuating interest rates is limited to our investment portfolio. A 10% decrease in interest rates in 2007, would result in a decrease in our interest income of $0.7 million. As of December 31, 2007, our investments were in commercial paper, corporate notes and bonds, auction rate securities, money market funds and U.S. government and agency securities.

Foreign Currency Risk

Our sales contracts are primarily denominated in United States dollars and therefore the majority of our net revenues are not subject to foreign currency risk. Our operating expense and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro and New Israeli Shekel. Exchange rate fluctuations have historically had relatively little impact on our operating results and cash flows. In the year ended December 31, 2007, the exchange rate fluctuation between the United States dollar and the Israeli New Shekel increased our operating expenses by approximately $0.8 million without hedging and $0.7 million with hedging. To protect against reductions in value and the volatility of future cash flows caused by changes in currency exchange rates, during August 2007 we established foreign currency risk management programs to hedge both balance sheet items and future forecasted expenses. Currency forward contracts and currency options are generally utilized in these hedging programs. Our hedging programs are intended to reduce, but will not always entirely eliminate, the impact of currency exchange rate movements. We considered the historical trends in currency exchange rates and determined that it was reasonably possible that adverse changes in exchange rates of 20% for all currencies could be experienced in the near term. Such adverse changes, without any hedging, would have resulted in an adverse impact on income before taxes of approximately $8.0 million in the year ended December 31, 2007.

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Item 8. Financial Statements and Supplementary Data

Index to Consolidated Financial Statements

The following financial statements are filed as part of this Annual Report:

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of
BigBand Networks, Inc.

We have audited the accompanying consolidated balance sheets of BigBand Networks, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of operations, redeemable convertible preferred stock and stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, and assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of BigBand Networks, Inc. as of December 31, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 3 to the consolidated financial statements, under the headings Stock-Based Compensation, Accounting for Income Taxes and Preferred Stock Warrants, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*", effective January 1, 2007, Statement of Financial Accounting Standards No. 123(R), "*Share-Based Payments*", effective January 1, 2006, and FASB Staff Position 150-5 (FSP150-5), "*Issuer's Accounting under Statement No. 150 for Freestanding Warrants and Other similar Instruments on Shares that are Redeemable*," during the year ended December 31, 2005.

/s/ ERNST & YOUNG LLP

Palo Alto, California
March 10, 2008

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BIGBAND NETWORKS, INC.

CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	As of December 31, 2007	As of December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 55,162	$ 38,570
Marketable securities	99,358	26,904
Trade receivables, net of allowance for doubtful accounts of $142 and $152 at December 31, 2007 and 2006, respectively	27,855	33,988
Inventories	6,832	7,153
Prepaid expenses and other current assets	4,012	2,511
Total current assets	193,219	109,126
Property and equipment, net	17,432	12,788
Intangible assets, net	734	1,306
Goodwill	1,656	1,656
Other non-current assets	5,545	4,174
Total assets	$ 218,586	$ 129,050
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 13,811	$ 15,109
Current portion of line of credit and loans payable	—	5,937
Preferred stock warrant liabilities	—	3,152
Accrued compensation and related benefits	6,475	7,354
Current portion of deferred revenues, net	48,256	39,553
Accrued warranty	3,502	3,241
Other current liabilities	11,879	9,724
Total current liabilities	83,923	84,070
Deferred revenues, net, less current portion	19,032	11,049
Loans payable, less current portion	—	8,599
Accrued warranty, less current portion	857	895
Accrued long-term severance pay fund	3,188	2,744
Commitments and contingencies (Note 6)		
Redeemable convertible preferred stock, $0.01 par value; 5,000 and 128,266 authorized at December 31, 2007 and 2006, respectively; 0 and 29,439, issued and outstanding at December 31, 2007 and 2006, respectively; aggregate liquidation value of $0 and $117,668 at December 31, 2007 and 2006, respectively	—	117,307
Stockholders' equity (deficit):		
Common stock, $0.001 par value, 250,000 and 335,000 shares authorized at December 31, 2007 and 2006		
Class A voting: 250,000 and 300,000 shares designated at December 31, 2007 and 2006; 61,907 and 8,241 shares issued and outstanding at December 31, 2007 and 2006	62	8
Class B nonvoting: zero and 35,000 shares designated at December 31, 2007 and 2006; zero and 3,619 shares issued and outstanding at December 31, 2007 and 2006	—	4
Additional paid-in capital	248,139	17,063
Deferred stock-based compensation	(203)	(1,405)
Accumulated other comprehensive income	248	9
Accumulated deficit	(136,660)	(111,293)
Total stockholders' equity (deficit)	111,586	(95,614)
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	$ 218,586	$ 129,050

See accompanying notes.

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BIGBAND NETWORKS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Years ended December 31, 2007	2006	2005
Net revenues			
Products	$ 144,715	$ 154,013	$ 85,966
Services	31,795	22,611	12,013
Total net revenues	176,510	176,624	97,979
Cost of net revenues			
Products	76,260	74,152	55,933
Services	13,414	9,245	3,900
Total cost of net revenues	89,674	83,397	59,833
Gross profit	86,836	93,227	38,146
Operating expenses			
Research and development	51,862	37,194	30,701
Sales and marketing	39,868	29,523	22,729
General and administrative	16,286	13,176	6,984
Restructuring charges	2,998	—	—
Amortization of intangible assets	572	572	573
Total operating expenses	111,586	80,465	60,987
Operating income (loss)	(24,750)	12,762	(22,841)
Interest income	6,863	1,526	628
Interest expense	(648)	(1,699)	(1,672)
Other expense, net	(5,607)	(1,187)	(652)
Net income (loss) before provision for income taxes and cumulative effect of change in accounting principle	(24,142)	11,402	(24,537)
Provision for income tax	1,225	2,525	325
Net income (loss) before cumulative effect of change in accounting principle	(25,367)	8,877	(24,862)
Cumulative effect of change in accounting principle	—	—	(633)
Net income (loss)	$ (25,367)	$ 8,877	$ (25,495)
Net income (loss) per common share:			
Basic	$ (0.52)	$ 0.78	$ (2.36)
Diluted	$ (0.52)	$ 0.16	$ (2.36)
Weighted average shares used in computing net income (loss) per common share:			
Basic	49,041	11,433	10,794
Diluted	49,041	57,053	10,794

See accompanying notes.

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BIGBAND NETWORKS, INC.

CONSOLIDATED STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)
(In thousands)

	Redeemable Convertible Preferred Stock		Common Stock Class A		Common Stock Class B		Additional Paid in Capital	Deferred Stock-based Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Stockholders' Equity
	Shares	Amount	Shares	Amount	Shares	Amount					
Balance as of December 31, 2004	29,439	$ 118,204	6,889	$ 7	3,619	$ 4	$ 14,038	$ (3,300)	$ —	$ (94,675)	$ (83,926)
Stock-based compensation	—	—	—	—	—	—	424	(424)	—	—	—
Amortization of deferred stock-based compensation	—	—	—	—	—	—	—	1,103	—	—	1,103
Proceeds from exercise of class A common stock options	—	—	644	1	—	—	516	—	—	—	517
Reclassification of warrants to liabilities	—	(897)	—	—	—	—	—	—	—	—	—
Comprehensive loss:											
Unrealized loss on marketable securities	—	—	—	—	—	—	—	—	(18)	—	(18)
Net loss	—	—	—	—	—	—	—	—	—	(25,495)	(25,495)
Total comprehensive loss	—	—	—	—	—	—	—	—	—	—	(25,513)
Balance as of December 31, 2005	29,439	117,307	7,533	8	3,619	4	14,978	(2,621)	(18)	(120,170)	(107,819)
Stock options issued to non-employees	—	—	—	—	—	—	26	—	—	—	26
Stock-based compensation	—	—	—	—	—	—	1,422	—	—	—	1,422
Amortization of deferred stock-based compensation, net of reversals	—	—	—	—	—	—	(114)	1,216	—	—	1,102
Proceeds from exercise of class A common stock options	—	—	708	—	—	—	751	—	—	—	751
Comprehensive income:											—
Unrealized gain on marketable securities	—	—	—	—	—	—	—	—	27	—	27
Net income	—	—	—	—	—	—	—	—	—	8,877	8,877
Total comprehensive income											8,904
Balance as of December 31, 2006	29,439	117,307	8,241	8	3,619	4	17,063	(1,405)	9	(111,293)	(95,614)
Conversion of class B common stock in class A common Stock	—	—	3,619	4	(3,619)	(4)	—	—	—	—	—
Conversion of preferred stock into class A common stock	(29,439)	(117,307)	37,762	38	—	—	117,269				117,307
Proceeds from initial public offering, net of expenses	—	—	7,500	8	—	—	87,761	—	—	—	87,769
Reclassification of preferred stock warrant liabilities to APIC upon IPO	—	—	—	—	—	—	8,125	—	—	—	8,125
Proceeds from exercise of common stock options	—	—	4,056	4	—	—	4,684	—	—	—	4,688
Proceeds from issuance of common stock under employee stock purchase plan	—	—	213	—	—	—	1,089	—	—	—	1,089
Tax benefit from stock options	—	—	—	—	—	—	25	—	—	—	25
Stock-based compensation	—	—	12	—	—	—	10,408	—	—	—	10,408
Net exercise for payment of tax liability for employee	—	—	—	—	—	—	(113)	—	—	—	(113)
Amortization of deferred stock-based compensation, net of reversals	—	—	—	—	—	—	(335)	1,202	—	—	867
Stock-based compensation related to non-employees in exchange for services	—	—	2	—	—	—	341	—	—	—	341
Exercise of warrants	—	—	502	—	—	—	1,822	—	—	—	1,822
							—				
Comprehensive loss:											
Net unrealized gains on cash flow hedges	—	—	—	—	—	—	—	—	42	—	42
Net unrealized gain on marketable securities	—	—	—	—	—	—	—	—	194	—	194
Net realized gain on cash flow hedges			—	—	—	—	—	—	3		3
Net loss	—	—	—	—	—	—	—	—	—	(25,367)	(25,367)
Total comprehensive loss											(25,128)
Balance as of December 31, 2007	—	$ —	61,907	$ 62	—	$ —	$ 248,139	$ (203)	$ 248	$ (136,660)	$ 111,586

See accompanying notes.

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BIGBAND NETWORKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years ended December 31, 2007	2006	2005
Cash Flows from Operating activities			
Net income (loss)	$ (25,367)	$ 8,877	$ (25,495)
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Depreciation of property and equipment	9,771	6,148	5,915
Amortization of intangible assets	572	572	573
Gain on sale of investment	—	(592)	—
Amortization of debt issuance costs	—	379	517
Loss on disposal of property and equipment	165	78	133
Revaluation of warrant liabilities	4,974	1,510	744
Stock-based compensation to non-employees	341	26	—
Stock-based compensation to employees	10,408	1,422	—
Amortization of deferred stock-based compensation	867	1,102	1,103
Change in operating assets and liabilities:			
Decrease (increase) in trade receivables	6,133	(19,280)	6,103
Decrease (increase) in trade receivables-related party	—	1,106	(146)
Decrease (increase) in inventories	321	14,371	(7,661)
Increase in prepaids and other current assets	(1,501)	(541)	(1,251)
Decrease (increase) in other noncurrent assets	(867)	(1,024)	318
Increase (decrease) in accounts payable	(1,286)	6,292	(1,491)
Increase (decrease) in accounts payable-related party	—	(1,531)	394
Increase in long-term severance pay fund	444	761	294
Increase (decrease) in accrued and other liabilities	(799)	7,282	2,714
Increase in deferred revenues	16,686	21,808	18,678
Net cash provided by operating activities	20,862	48,766	1,442
Cash Flows from Investing activities			
Purchases of marketable securities	(170,460)	(46,925)	(15,399)
Proceeds from maturities of marketable securities	78,445	26,969	8,460
Proceeds from sale of marketable securities	19,800	—	—
Proceeds from sale of other investment	—	592	5,259
Purchase of property and equipment	(12,320)	(10,943)	(5,980)
Proceeds from sale of property and equipment	40	—	—
Decrease (increase) in restricted cash	(505)	87	(42)
Net cash used in investing activities	(85,000)	(30,220)	(7,702)
Cash Flows from Financing activities			
Proceeds from loans	—	16,800	—
Principal payments on loans	(14,494)	(14,012)	(247)
Principal payments on capital lease obligations	(56)	(210)	(440)
Payments in preparation for an initial public offering of the Company's common stock	—	(671)	—
Proceeds from exercise of warrants to purchase common stock	1,822	—	—
Proceeds from exercise of common stock options, net of tax liability, for employee plans	4,575	751	517
Proceeds from issuance of common stock under employee stock plans	1,089	—	—
Proceeds from initial public offering, net of expenses	87,769	—	—
Tax benefit from stock options	25	—	—
Net cash provided by (used in) financing activities	80,730	2,658	(170)
Net increase (decrease) in cash and cash equivalents	16,592	21,204	(6,430)
Cash and cash equivalents at beginning of year	38,570	17,366	23,796
Cash and cash equivalents at end of year	$ 55,162	$ 38,570	$ 17,366
Schedule of non-cash transactions			
Equipment acquired under loan agreement	$ —	$ 480	—
Accrued leasehold improvements	$ 2,300	—	—
Supplemental disclosure of cash flow information			
Interest paid	$ 514	$ 1,398	$ 1,038
Income taxes paid	$ 3,945	$ 360	$ 4

See accompanying notes.

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BIGBAND NETWORKS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

BigBand Networks, Inc. (BigBand or the Company), headquartered in Redwood City, California, was incorporated on December 3, 1998, under the laws of the state of Delaware and commenced operations in January 1999. BigBand develops, markets and sells network-based hardware and software platforms that enable cable operators and telecommunications providers to deploy advanced video, voice and data services and more effective video advertising.

Initial Public Offering

On March 20, 2007, the Company completed an initial public offering of its common stock in which the Company sold and issued 7,500,000 shares of its common stock and selling stockholders sold 4,805,000 shares of the Company's common stock, in each case at a public offering price of $13.00 per share. The Company raised a total of $97.5 million in gross proceeds from the IPO, or approximately $87.8 million in net proceeds after deducting underwriting discounts and commissions of $6.8 million and other offering costs of approximately $2.9 million.

2. Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Management uses estimates and judgments in determining recognition of revenues, valuation of inventories, valuation of stock-based awards, provision for warranty claims, the allowance for doubtful accounts, restructuring costs, valuation of goodwill and other purchased intangible assets and long-lived assets. Management bases its estimates and assumptions on methodologies it believes to be reasonable. Actual results could differ from those estimates, and such differences could affect the results of operations reported in future periods.

Reclassifications

Certain prior-year balances have been reclassified to conform to current financial statement presentation. These reclassifications had no impact on previously reported results of operations or stockholders' equity.

Revenue Recognition

The Company's software and hardware are sold as solutions and its software is a significant component of the product. The Company provides unspecified software updates and enhancements related to products through support contracts. As a result, the Company accounts for revenues in accordance with Statement of Position (SOP) 97-2, "Software Revenue Recognition," as amended by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions," for all transactions involving the sale of products with a significant software component. Revenue is recognized when all of the following have occurred: (1) the Company has entered into an arrangement with a customer; (2) delivery has occurred; (3) customer payment is fixed or determinable and free of contingencies and significant uncertainties; and (4) collection is probable.

Product revenues consist of revenues from sales of the Company's software and hardware. Product sales include a perpetual license to the Company's software. The Company recognizes product revenues upon shipment to its customers, including channel partner distributors, on non-cancelable contracts and purchase orders when all revenue recognition criteria are met, or, if specified in an agreement, upon receipt of final acceptance of the product, provided all other criteria are met. End users, channel partners, and distributors generally have no rights of return, stock rotation rights, or price protection. Shipping charges billed to customers are included in product revenues and the related shipping costs are included in cost of product revenues.

The Company provides allowances for trade-in credits that are estimated based on the terms of the arrangement and past history and adjusted periodically based on actual experience or future expectation. Allowances for trade-in credits are recorded as a liability or reductions of trade receivables.

Substantially all of the Company's product sales have been made in combination with support services, which consist of software updates and support. The Company's customer service agreements (CSA) allow customers to select from plans offering various levels of technical support, unspecified software upgrades and enhancements on an if-and-when-available basis. Revenues for support services are recognized on a straight-line basis over the service contract term, which is typically one year but can extend to five (5) years for our telephone company customers. Revenues from other services, such as standard installation and training, are recognized when services are performed.

The Company uses the residual method to recognize revenues when a customer agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence (VSOE) of the fair value of all undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract fee is recognized as product revenues. If evidence of the fair value of one or more undelivered elements does not exist, all revenues are deferred and recognized when delivery of those elements occur or when fair value can be established. When the undelivered element is customer support and there is no evidence of fair value for this support, revenue for the entire arrangement is bundled and revenue is recognized ratably over the service period. VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for those services when sold separately.

Fees are typically considered to be fixed or determinable at the inception of an arrangement based on specific products and quantities to be delivered. In the event payment terms are greater than 180 days, the fees are deemed not to be fixed or determinable and revenues are recognized when the payments become due, provided the remaining criteria for revenue recognition have been met.

Deferred revenues consist primarily of deferred product revenues, net of the associated costs, and deferred service fees. Deferred product revenue generally relates to acceptance provisions that have not been met or partial shipment or when the Company does not have VSOE of fair value on the undelivered items. When deferred revenues are recognized as revenues, the associated deferred costs are also recognized as cost of sales. The Company assesses the ability to collect from its customers based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. If the customer is not deemed credit worthy, all revenues are deferred from the arrangement until payment is received and all other revenue recognition criteria have been met.

Cash and Cash Equivalents

The Company holds its cash and cash equivalents in checking, money market, and investment accounts with high credit quality financial instruments. The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents.

Marketable Securities

Marketable securities consist principally of corporate debt securities, commercial paper, auction rate securities, and U.S. agencies with remaining time to maturity of two years or less. Auction rate securities are

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considered short-term marketable securities due to their reset feature which is seven, twenty eight or thirty five days. The Company considers marketable securities with remaining time to maturity greater than one year and in a consistent loss position for at least nine months to be classified as long-term as it expects to hold them to maturity. The Company considers all other marketable securities with remaining time to maturity less than two years to be short-term marketable securities. The short-term marketable securities are classified in the balance sheet as current assets because they can be readily converted into cash or into securities with a shorter remaining time to maturity and because the Company is not committed to holding the marketable securities until maturity. The Company determines the appropriate classification of its marketable securities at the time of purchase and reevaluates such designations as of each balance sheet date. All marketable securities and cash equivalents in the portfolio are classified as "available-for-sale" and are stated at fair market value, with all the associated unrealized gains and losses, net of taxes, reported as a component of accumulated other comprehensive income (loss). Fair value is based on quoted market rates. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in interest income and other expenses, net. Additionally, the Company assesses whether an other-than-temporary impairment loss on its investments has occurred due to declines in fair value or other market conditions. The Company did not consider any declines in fair value of securities held on December 31, 2007 to be other-than-temporary. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest income, net of taxes. The cost of securities sold and any gains and losses on sales are based on the specific identification method.

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, restricted cash, trade receivables, marketable securities, derivatives used in the Company's hedging program, accounts payable, and other accrued liabilities approximate their fair value. The carrying values of the Company's capital lease obligations, loans payable, preferred stock warrant liability, other long-term liabilities approximate their fair value. The fair value of preferred stock warrant liabilities was estimated using the Black-Scholes valuation model.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash equivalents, marketable securities, trade receivables, and restricted cash. Cash equivalents, restricted cash, and marketable securities are invested through major banks and financial institutions in the United States and Israel. Such deposits in the United States may be in excess of insured limits and are not insured in Israel. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments. The Company's trade receivables are derived primarily from cable and telecommunications operators located mainly in the United States. Concentrations of credit risk with respect to trade receivables exist to the full extent of amounts presented in the financial statements. The Company performs ongoing credit evaluations of its customers and in certain circumstances may require letters of credit or other collateral. The Company estimates an allowance for doubtful accounts through specific identification of potentially uncollectible accounts based on an analysis of its trade receivables aging. Unless otherwise provided, trade receivables are identified as past due when outstanding more than 30 days from the invoice date. Uncollectible receivables are written off against the allowance for doubtful accounts when all efforts to collect them have been exhausted. Recoveries are recognized when they are received. Actual collection losses may differ from estimates and could be material to the consolidated financial position, results of operations, and cash flows.

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Customers with trade receivables balances of 10% or greater of the total trade receivables balances as of December 31, 2007 and 2006, and customers representing 10% or greater of net revenues for the years ended December 31, 2007, 2006, and 2005 are as follows:

Customers	Percentage of Total Trade Receivables as of December 31, 2007	2006	Percentage of Net Revenues for the Periods Ended December 31, 2007	2006	2005
A	*%	*%	*%	*%	37%
B	19	11	11	13	20
C	*	*	*	10	*
D	18	36	13	19	10
E	*	37	40	32	*
F	22	*	*	*	*

* Represents less than 10%

Management makes judgment as to the Company's ability to collect outstanding receivables when collection becomes doubtful. Provisions are made based upon specific review of the outstanding invoices.

Activity related to allowance for doubtful accounts consisted of the following (in thousands):

	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions-Write-offs	Balance at End of Year
Year ended				
December 31, 2007	$ 152	$ 99	$ (109)	$ 142
December 31, 2006	$ 23	$ 129	$ —	$ 152
December 31, 2005	$ 23	$ —	$ —	$ 23

Inventories

Inventories consist of raw materials, work-in-process, and finished goods and are stated at lower of standard cost or market. Standard costs approximate the first-in, first-out (FIFO) method. The Company regularly monitors inventory quantities on-hand and records write-downs for excess and obsolete inventories based on the Company's estimate of demand for its products, potential obsolescence of technology, product life cycles, and whether pricing trends or forecasts indicate that the carrying value of inventory exceeds its estimated selling price. These factors are impacted by market and economic conditions, technology changes, and new product introductions and require estimates that may include elements that are uncertain. Actual demand may differ from forecasted demand and may have a material effect on gross margins. If inventory is written down, a new cost basis will be established that can not be increased in future periods.

Property and Equipment, Net

Property and equipment, net are stated at cost, less accumulated depreciation. Depreciation is calculated using the straight-line method and recorded over the estimated useful lives of the assets ranging from 18 months to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Repair and maintenance costs are expensed as incurred.

The cost of equipment under capital leases is recorded at the lower of the present value of the minimum lease payments or the fair value of the assets and is amortized on a straight-line basis over the shorter of the term of the related lease or the estimated useful life of the asset. Amortization of assets under capital leases is included with depreciation expense in the accompanying consolidated statements of cash flows.

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Intangible Assets

Intangible assets consist of patented products, customer relationships, and trade names. Intangible assets are carried at cost less accumulated amortization. Amortization is computed using the straight-line method and recorded over the estimated useful lives of the respective assets of four to five years.

Impairment of Long-Lived Assets

The Company periodically evaluates whether changes have occurred that require revision of the remaining useful life of long-lived assets or would render them not recoverable. If such circumstances arise, the Company compares the carrying amount of the long-lived assets to the estimated future undiscounted cash flows expected to be generated by the long-lived assets. If the estimated aggregate undiscounted cash flows are less than the carrying amount of the long-lived assets, an impairment charge, calculated as the amount by which the carrying amount of the assets exceeds the fair value of the assets, is recorded. The fair value of the long-lived assets is determined based on the estimated discounted cash flows expected to be generated from the long-lived assets. Through December 31, 2007, no impairment losses have been recognized.

Goodwill

Goodwill is tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Based on the impairment tests performed, there was no impairment of goodwill during the years ended December 31, 2007 and 2006.

Software Development Costs

Software development costs are capitalized beginning when technological feasibility has been established and ending when a product is available for sale to customers. To date, the period between achieving technological feasibility and when the software is made available for sale to customers has been relatively short and software development costs qualifying for capitalization have not been significant. As such, all software development costs have been expensed as incurred in research and development expense.

Accounting for Income Taxes

Effective January 1, 2007, the Company adopted Financial Accounting Standards Interpretation, or FIN, No. 48, "*Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*" (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a company's income tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 utilizes a two-step approach for evaluating uncertain tax positions accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109). Step one, *Recognition*, requires a company to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two, *Measurement*, is based on the largest amount of benefit, which is more likely than not to be realized on ultimate settlement. The cumulative effect of adopting FIN 48 on January 1, 2007 is recognized as a change in accounting principle, recorded as an adjustment to the opening balance of retained earnings on the adoption date. As a result of the implementation of FIN 48, the Company recognized no change in the liability for unrecognized tax benefits related to tax positions taken in prior periods, and no corresponding change in retained earnings. Additionally, FIN 48 specifies that tax positions for which the timing of the ultimate resolution is uncertain should be recognized as long-term liabilities. The Company made no reclassifications between current taxes payable and long term taxes payable upon adoption of FIN 48. The Company's total amount of unrecognized tax benefits as of the January 1, 2007 adoption date and December 31, 2007 was $1.3 million and $1.4 million,

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respectively. In 2007, changes to the amount of unrecognized tax benefits from U.S. federal and state research and development credits and other tax positions are detailed as follows (in millions):

	Unrecognized Tax Benefit
Balance at January 1, 2007	$ 1,319
Add:	
Additions for tax positions of prior years	—
Additions for tax positions related to 2007	532
Less:	
Reductions for tax positions of prior years	(446)
Settlements during the current year	—
Balance at December 31, 2007	$ 1,405

Also, the Company had no amounts of unrecognized tax benefits that, if recognized, would materially affect its effective tax rate. It is expected that the amount of unrecognized tax benefits will change during the next year; however, the Company does not expect the change to have a material impact on its financial position.

Upon adoption of FIN 48, the Company's policy to include interest and penalties related to unrecognized tax benefits within the Company's provision from income taxes did not change. As of December 31, 2007, the Company had no amount accrued for payment of interest and penalties related to unrecognized tax benefits and no amounts as of the adoption date of FIN 48. In 2007 and 2006, the Company recognized no amounts of interest and penalties related to unrecognized tax benefits in its provision for income taxes.

The Company's only major tax jurisdictions are the United States and Israel. The tax years 1998 through 2006 remain open and subject to examination by the appropriate governmental agencies in the U.S. and the tax years 2004 through 2006 remain open and subject to examination by the appropriate governmental agencies in Israel.

Hedging Instruments

The Company has sales, expenses, assets and liabilities denominated in currencies other than the U.S. dollar and subject to foreign currency risks, primarily related to expenses and liabilities denominated in the New Israeli Shekel. Beginning in 2007, the Company established a foreign currency risk management program to protect against the impact of foreign currency exchange rate movements on the Company's operating results. The Company does not enter into derivatives for speculative or trading purposes. The Company's practice is to use foreign currency forward contracts or combinations of purchased and sold foreign currency option contracts to reduce its exposure to foreign currency exchange rate fluctuations. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

The Company also enters into foreign currency forward contracts to reduce the impact of foreign currency fluctuations on assets and liabilities denominated in currencies other than the functional currency of the reporting entity. These forward contracts are not subject to the hedge accounting provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, (referred to as SFAS 133) but are carried at fair value with changes in the fair value recorded within other income or expense, net, on the statement of operations in accordance with SFAS No. 52, "Foreign Currency Translation". These derivative instruments generally have maturities of 90 days or less. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated assets and liabilities, primarily liabilities denominated in New Israeli Shekels, and therefore, do not subject the Company to material balance sheet risk. Any gain or loss from these forward contracts is recognized in other income or expense in the period of change, including any unrealized gains or losses at period end. The unrealized gain on forward contracts that were open at December 31, 2007 was $11,000 and the notional amount was $4.1 million.

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The Company selectively hedges future expenses denominated in the Israeli New Shekel by purchasing foreign currency forward contracts or combinations of purchased and sold foreign currency option contracts. The exposures are hedged using derivatives designated as cash flow hedges under SFAS No. 133. The effective portion of the derivative's gain or loss is initially reported as a component of accumulated other comprehensive income (loss) and, upon occurrence of the forecasted transaction, is subsequently reclassified into the consolidated statement of operations line item to which the hedged transaction relates. The ineffective portion of the gain or loss is reported in other income or expense, net immediately. These derivative instruments generally have maturities of 90 days or less. At December 31, 2007, the amount of net unrealized and realized gains on derivatives designated as cash flow hedges and recorded in other comprehensive income is not significant. The notional amount of the purchased currency option contracts, which are combined with sold currency option contracts, is $7.9 million at December 31, 2007.

Israeli Severance Pay Fund

The Company's wholly owned subsidiary located in Israel is required to fund future severance liabilities determined in accordance with Israeli severance pay laws. Under these laws, employees are entitled upon termination to one month's salary for each year of employment or portion thereof. The Company records compensation expense to accrue for these costs over the employment period. This liability is funded through the contributions invested by the subsidiary on behalf of the employees. The value of these contributions are recorded in other non-current assets. The provision for severance expenses for the years ended December 31, 2007, 2006, and 2005, amounted to approximately $2.2 million, $1.8 million, and $0.8 million, respectively.

Stock-based Compensation

Prior to January 1, 2006, the Company accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board Interpretation, or FIN, 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25,* and had adopted the disclosure only provisions of Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation,* and SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure,* using the minimum value method.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment* (SFAS 123R). Under SFAS 123R, stock-based awards, including stock options, are recorded at fair value as of the grant date and recognized to expense over the employee's requisite service period (generally the vesting period), which the Company has elected to amortize on a straight-line basis. The Company adopted the provisions of SFAS 123R using the prospective transition method. Under this transition method, non-vested stock-based awards outstanding as of January 1, 2006 continued to be accounted for under the intrinsic value method.

At December 31, 2007, the Company had one share-based compensation plan, which is described in Note 10. The Company allocated stock-based compensation expense as follows (in thousands):

	Years ended December 31,		
	2007	2006	2005
Cost of net revenues	$ 1,534	$ 336	$ 87
Research and development	3,837	1,035	516
Sales and marketing	4,184	637	263
General and administrative	2,061	542	237
Total Stock-based compensation expense	$ 11,616	$ 2,550	$ 1,103